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IN THE

Supreme Court of the United States

OCTOBER TERM, 1996

SHEA & GOULD AND SHELDON CAMHY,
Petitioners,

vs.

RONALD L. DURKIN,
TRUSTEE OF THE BENCHMARK IRREVOCABLE TRUST.
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

RESPONDENT'S BRIEF IN OPPOSITION

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March 28, 1997

QUESTION PRESENTED

May defendant lawyers rely on a prior settlement of shareholder derivative and class claims as a defense to their client's malpractice claims, where the prior court's findings resulted from the lawyers' own malpractice, where no finding was made as to the quality of the lawyers' representation, and where the client corporation's insolvency deprived the parties of any incentive to litigate the findings actually made?

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RESPONDENT'S BRIEF IN OPPOSITION

Respondent Ronald L. Durkin, Trustee of the Benchmark Irrevocable Trust ("Durkin"), respectfully requests that this Court deny the Petition for Writ of Certiorari filed by Petitioners Shea & Gould and Sheldon Camhy (the "Shea Defendants").

STATEMENT OF THE CASE

The Petition arises out of an interlocutory appeal of an order denying summary judgment. The court of appeals held that Durkin, the court-appointed representative of the

bankruptcy estate of Imperial Corporation of America ("ICA"), could proceed with his malpractice suit against ICA's former lawyers, the Shea Defendants. The court of appeals reasoned that the issues in the malpractice case were different from those in the original litigation; that, as a matter of California law, the lawyers could not block a malpractice case by invoking the fruits of their prior alleged malfeasance; and that there was no full and fair opportunity to litigate the issues of malpractice in the prior lawsuit. In view of these holdings, there is no basis for Supreme Court review of this malpractice case at this time. Questions about the defenses of the ICA directors and officers are not before this Court.

Although the Shea Defendants' motion for summary judgment was filed at the beginning of discovery, Durkin presented the district court with an array of facts tending to show that Shea & Gould had a substantial conflict of interest and had failed to disclose to the magistrate material information bearing on the fairness of the settlement. These facts are briefly summarized below.

A. The Underlying Actions

ICA was the parent company of Imperial Savings Association ("ISA"), a $12-billion federally insured savings and loan. Beginning in 1986, the Board of Directors of Imperial embarked on a program of high-risk investments, including $1.5 billion in junk bonds and $1.2 billion in substandard consumer loans. Imperial's losses triggered a shareholder derivative action (the "Shields Lawsuit"), which asserted claims on behalf of ICA against its directors and officers and others for breach of fiduciary duty and waste of corporate assets. The Shields Lawsuit also asserted class claims for securities fraud on behalf of ICA shareholders against ICA directors and officers.

In response, the ICA Board created a Special Litigation Committee. Its chair was director Allan R. Tessler, then "of counsel" to Shea & Gould, and its other members were defendants in the Shields Lawsuit. The committee's purported role was to conduct an "impartial review, analysis and investigation" of the lawsuit's allegations. CR 490 Ex. D at 4.[1]

One week later, shareholders sent a letter to the ICA Board demanding that added claims be filed against Tessler and First Executive Corporation based on allegations that they had conspired with Michael Milken and Drexel Burnham Lambert ("Drexel") to sell risky investments to Imperial. CR 490 Ex. I; CR 67 Exs. B & D. Tessler then retained the law firm of Proskauer Rose Goetz & Mendelsohn (the "Proskauer Firm") to analyze and investigate some (but not the Drexel-related) shareholder claims. *Id.*

B. ICA's Retention of Shea & Gould

In April 1989, the plaintiffs in the Shields Lawsuit sent ICA a draft amended complaint that added Tessler as a defendant. At this point, at Tessler's urging, the Special Litigation Committee retained Sheldon Camhy of Shea & Gould as counsel to ICA for the purpose of negotiating an early settlement of the Shields Lawsuit. CR 490 Ex. F. Tessler had been Camhy's law partner since 1976. Tessler was then "of counsel" to Shea & Gould, an individual client of that firm, and a controlling shareholder in other companies that were Shea & Gould clients.[2] Shea & Gould thus was retained to represent ICA in settling a suit potentially

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[1] "CR" refers to the Clerk's Record in the district court.

[2] Discovery conducted after the district court denied the Shea Defendants' summary judgment motion has revealed that Tessler received his "of counsel" compensation based on business that he introduced to the firm, including the firm's representation of ICA in the underlying actions. 1 Tessler Dep. 21-33; 3 *id.* 548-51; Mem. from Sheldon Camhy to Jim Cunningham of ICA (Oct. 11, 1989).

against one of its own lawyers and a major source of the firm's business.

Camhy proceeded to play a key role in the settlement. A settlement dollar figure was negotiated between Camhy and William Lerach, counsel to the plaintiffs in the Shields Lawsuit. CR 490 Ex. F; CR 865 Ex. 23 at 2. This occurred in May 1989, before the Proskauer Firm had prepared any report or findings.

By this time, however, the outside directors' law firm had already concluded that the claims of mismanagement of Imperial were well-founded. CR 490 Ex. G at 6. Counsel relayed that analysis to the Board, stating that "[w]e believe the [insurer's] investigation will confirm [the directors' law firm's] conclusions that there has been reckless conduct which caused loss." *Id.* Ex. J at 3. One month later, the Proskauer Firm preliminarily concluded that "as to certain senior executives . . . the claims of gross mismanagement were well founded." *Id.* Ex. N at 1.

The Shea Defendants were familiar with these conclusions: Camhy attended a July 3, 1989 meeting of the ICA Board at which Tessler read these findings into the minutes. *Id.* Ex. L. Based on this information, the ICA Board requested the resignation of ICA's President and Chief Executive Officer, and appointed Tessler as interim President and Chief Executive Officer. *Id.* Exs. K & L.[3]

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[3] Subsequent discovery has revealed that the role of Camhy and his partner Kurt Hunciker "increasingly expanded" into "consumer lending problems" and "junk bond issues," such that Hunciker "was getting involved in everything" and "was almost functioning in the position similar to [assistant general counsel of ICA]." 2 Annen Dep. 292.

C. Settlement of the Underlying Actions Before Regulators Seized ISA

By this time, ICA's financial condition was failing. The October 9, 1989 issue of *Barron's* magazine reported ICA's negative tangible net worth and noted that "[b]y some interpretations, it was susceptible to federal seizure and by other interpretations it was insolvent." CR 928 Ex. C at 26. A worksheet prepared by federal regulators as of October 31, 1989 showed negative tangible capital of $277.5 million. CR 490 Ex. O at 1. After the *Barron's* article, ICA shareholders filed four additional derivative lawsuits, naming Tessler, Milken, and Drexel as defendants in three of them.

The Shea Defendants assisted the ICA Board in a series of actions designed to obtain judicial approval of a settlement before ISA was seized by the government. In November, Camhy and Lerach worked out the final details of the settlement and recommended Board approval of the settlement in principle. CR 490 Ex. P. Camhy advised that any contribution from ICA would require the approval of its Board. *Id.* On November 30, after a twenty-minute discussion of the proposed settlement, ICA's Special Litigation Committee and Board approved resolutions to settle the suits against themselves, and authorized a contribution of cash from the company. *Id.* Exs Q & R. Within two weeks, Shea & Gould partner Kurt Hunciker and other counsel notified the district court that the case had been settled. Minute Entry (Dec. 8, 1989). The ICA Board--each of whose members was voting to settle claims against himself--approved the Stipulation of Settlement by a unanimous written consent dated December 15, 1989. *Id.* Ex. S.

The essence of the settlement was a $13 million cash payment to the shareholder class in exchange for complete releases. ICA's D&O liability insurer paid $12.5 million in cash to the shareholder plaintiffs. ICA was required to pay

another $500,000 plus interest directly to the shareholder class. The settlement released all of ICA's claims against the ICA directors and officers for their role in mismanagement of the institution, and also gave complete releases to defendants such as Milken and Drexel. CR 490 Ex. U at 18-20. None of these released defendants contributed anything to the settlement.

By the time a tentative settlement was reached, news of ICA's negative capital had inspired forecasts that federal regulators would soon seize ISA. On December 20, 1989, analysts in *The American Banker* predicted that Imperial "would be seized by regulators because it is insolvent under generally accepted accounting principles," but some time might pass before that happened because "'regulators are working to capacity' on other problem thrifts." CR 490 Ex. T. Subsequent discovery has revealed added evidence of ICA's insolvency and the federal regulators' course toward seizure.[4] It has also revealed that the parties to the settlement anticipated the seizure and endeavored to finalize the settlement and obtain their releases before the regulators acted.[5] Thus, on January 11, 1990, counsel for ICA and the other parties signed a formal Stipulation of Settlement.

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[4] On January 4, 1990, the U.S. Office of Thrift Supervision ("OTS") delivered to ISA an "unsafe and unsound letter" stating that ISA was a troubled institution and ordering the thrift to cease its lending and investment activities. Letter from Supervisory Agent R.A. Sanchez to ISA (Jan. 4, 1990). On February 14, 1990, the OTS and FDIC auditors made a presentation to the ICA Board and senior management on ISA's financial condition, at which "[m]anagement . . . conceded the insolvency." FDIC Report of Examination No. 1761 (Archer Dep. Ex. 21233).

[5] On October 26, 1989, the plaintiffs' lead counsel expressed to Sheldon Camhy and others his "concerns that . . . Imperial's continuing deteriorating financial condition has made it likely that there will be a regulatory seizure of the institution in a manner that

(continued ...)

D. Misrepresentations to the Court in the Settlement Approval

After notice to ICA's shareholders (but not its creditors), a hearing on the settlement was held before U.S. Magistrate Harry McCue on February 22, 1990.[6] The papers filed in advance of the hearing provided no discussion of ICA's insolvency or the fairness of the derivative settlement. CR 490 Ex. V. At that hearing, none of the parties made any presentation concerning the insolvency of ICA, the imminent seizure of ISA, or the directors' consequent fiduciary duties to ICA's creditors. CR 490 Ex. W. Nor did the parties discuss the merits and immense value of the derivative claims or the results of any of the internal investigations, including the conclusions provided to the ICA Board at its July 3, 1989 meeting.

To the contrary, Charles Bird, personal counsel to the directors, remarked: "On the derivative side, there is

[5] (... continued)
would eliminate the corporate entity as a potential contributor to a settlement." CR 865 Ex. 61 at 1. On December 11, 1989, the outside directors' counsel warned that a "regulatory takeover before the settlement closes . . . would almost certainly be a material change of circumstances which could cause the court not to approve the settlement." CR 865 Ex. 59 at 3. On January 11, 1990, the directors' counsel reiterated that "concern about the possible regulatory takeover of the company. Such . . . an order would likely provide basis and incentive for objectors to advocate court rejection of the settlement. It is also possible that the OTS would file an objection. Therefore, it is important that every proper effort be undertaken to avoid takeover." CR 865 Ex. 60 at 1-2.

[6] The Shea Defendants' assertion that "[f]ederal regulators were promptly notified of the impending settlement," Pet. at 4, is contradicted by the record. An ICA inhouse lawyer has claimed that on February 14, 1990 -- only eight days before the approval hearing -- an OTS lawyer asked him for a copy of the settlement documentation. The ICA lawyer could not recall what he gave the OTS or when he did so. 5 Annen Dep. at 730-34.

nothing in this case that approaches the kinds of acts and omissions which would be required to impose liability on these directors." *Id.* at 13. Neither Kurt Hunciker of Shea & Gould nor any other counsel present contradicted that representation. *Id.* Based on the representations of counsel, Magistrate McCue approved the settlement and signed an order of dismissal with prejudice. CR 463 Ex. B.

On February 22, 1990--the day the court approved the settlement--the OTS issued an order appointing the Resolution Trust Corporation ("RTC") as conservator for ISA, and within 24 hours federal regulators seized ISA and placed it into conservatorship. OTS Order No. 90-375 (Feb. 22, 1990). ICA filed a chapter 11 bankruptcy petition six days later on February 28.

E. Proceedings Below

On January 4, 1991, the bankruptcy court appointed respondent Durkin as the trustee of the Benchmark Irrevocable Trust and the representative of ICA's bankruptcy estate under 11 U.S.C. § 1123(b)(3)(B). CR 338 at 4-15. A little more than a year later, after discovering and investigating the misconduct of the defendants, Durkin commenced this action against the directors, officers, lawyers, and derivative plaintiffs who should have been representing ICA's interests but failed to do so.[7] Durkin sued Shea & Gould and its partners Sheldon Camhy and Kurt Hunciker for malpractice, claiming that, among other things, they failed to advise the ICA Board as to the need for disinterested persons to make decisions about the derivative claims; failed to advise the

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[7] Durkin's Third Amended Complaint alleges fiduciary duty and bankruptcy avoidance claims against the directors and officers, the derivative plaintiffs, and the derivative plaintiffs' lawyers for their roles in the settlement. Those claims have been repeatedly upheld by the district court and remain pending, but, as the court of appeals ruled, are not within the scope of this interlocutory appeal. Pet. at 30a.

ICA Board of its duties to creditors in light of ICA's insolvency; failed to protect the interests of ICA in negotiating the settlement; and failed to conduct an investigation into the value of claims against third parties before releasing them for no consideration.

The first two years of litigation were consumed by motion practice, during which the district court stayed discovery. CR 32 at 13; CR 862. The district court certified two orders for interlocutory appeal under 28 U.S.C. § 1292(b), but the court of appeals accepted only one. The court of appeals *denied* review of the district court's June 22, 1994 order, issued in the RTC's consolidated action, concerning issue and claim preclusion arguments of the defendant directors and officers. Orders in Nos. 94-80389 & 94-80390 (9th Cir. Dec. 21, 1994); CR 510 at 8-10 (district court).

The court of appeals *granted* review of the July 12, 1994 order, which concerned the malpractice claims against the Shea Defendants. In its July 1994 order, the district court held that, under California law, the Shea Defendants could not claim issue preclusion based on a judgment that resulted from their own alleged malpractice. In addition, the court held that issue preclusion did not apply because the issues raised by Durkin's claims were not actually litigated in the prior case. The court also ruled that ICA had not had a "full and fair opportunity" to litigate settlement issues in the prior case. Finally, the court denied partial summary judgment on whether Shea & Gould's advice constituted malpractice because such issues could not be decided before any real opportunity for discovery. Pet. at 4a-7a.

On appeal under section 1292(b), the court of appeals affirmed. First, it held that the prior court had never decided (i) whether the Shea Defendants adequately represented the interests of ICA, particularly in light of the

insolvent corporation's duties to its creditors; and (ii) whether the settlement was reasonable for purposes of a state-law malpractice action. Second, the court of appeals held that, given the allegations of ICA's insolvency and the parties' incentives *not* to litigate the derivative claims, ICA did not have a "full and fair opportunity to litigate" in the prior action. Pet. at 37a. Third, the court concluded that the nature and existence of the Shea Defendants' duties to ICA raised issues of fact that could not be decided prior to complete discovery. *Id.* at 38a. Finally, the court held that, under California malpractice law, an attorney defendant is barred from using a settlement or judgment that was entered as the result of his alleged malpractice to defend the malpractice action. *Id.* at 38a-39a.

The Shea Defendants filed a petition for rehearing and suggestion for rehearing en banc. It did not receive a single vote among the judges of the Ninth Circuit, and was therefore denied.

REASONS FOR DENYING THE WRIT

The questions presented in the Petition do not warrant review by this Court and could not, in any event, be resolved in this appeal.

First, there is no intercircuit or other conflict for this Court to review. The Shea Defendants argue that the court of appeals' opinion conflicts with decisions of other circuits recognizing the preclusive effect of derivative and class settlements. Pet. at 9. But addressing the issues on such a high level of generality misses crucial distinctions recognized by the court of appeals. The court recognized that the Shea Defendants' appeal concerned only a malpractice action against lawyers who negligently failed to advise their corporate client as to a settlement. Those malpractice claims do not constitute a "collateral attack" on the prior

judgment; to the contrary, the malpractice claims *assume* the judgment's legal validity and seek to hold the lawyer responsible for its entry.

In fact, the court below concluded that the findings made in the prior action did not determine the issues raised in this malpractice action. The adequacy of the shareholder counsel's representation of the shareholder class is not the same as the adequacy of the corporate counsel's representation of the corporation, including its creditors, at a time when the corporation is insolvent. Further, the adequacy of a settlement for purposes of court approval is not the same issue as whether, if the corporation's counsel had been competent and unconflicted, the corporation would have done better. Because the court of appeals relied on the distinctiveness of malpractice issues, its decision does not conflict with decisions from other circuits rejecting successive derivative and class actions.

Moreover, no other reported decision deals with a settlement of a derivative case brought on behalf of a corporation known to be insolvent at the time of settlement. Such insolvency significantly changed the directors' and others' fiduciary duties to the corporation's creditors. In conjunction with the Shea Defendants' own conflicts of interest, ICA's insolvency also left the parties with strong disincentives to contest the critical issues, thereby depriving ICA of the requisite "full and fair opportunity to litigate." These unusual circumstances distinguish this cases from the ordinary Rule 23.1 case.

At the same time, both the district court and the court of appeals below relied on state malpractice law as independent grounds. For example, they held that, under California law, a lawyer defendant cannot claim preclusion based on a judgment procured as a result of the lawyer's own malpractice. The Shea Defendants have not controverted this

doctrine of California law. Given this Court's usual reluctance to review a circuit court's construction of state law, there is little reason to believe that review of federal issues by this Court would change the outcome.

Finally, both the district court and the court of appeals found that the case presents unresolved issues of fact. They both found contested factual issues as to the scope of the Shea Defendants' duties and whether they breached those duties. For example, the Shea Defendants contend that they "could not enforce the claims asserted in the *Shields* action for ICA." Pet. at 23-24. To consider that contention, the Court would require a fully developed record. That record was barely begun when the Shea Defendants filed their motion, and it is still not completed. As a result, this appeal presents an unsuitable vehicle for considering the questions presented.

I. THERE IS NO CIRCUIT CONFLICT.

A. The Decision Below Does Not Conflict with Decisions Involving Successive Class or Derivative Claims.

Despite the multitude of cases cited in the Petition, the Shea Defendants have failed to demonstrate a true conflict with the decision below. As the court of appeals recognized, this is a malpractice case, not a repetitive derivative suit. This malpractice action concerns the conduct of the lawyers in settling the derivative lawsuit, and the particular findings made by the magistrate did not bear on the conduct of corporate counsel. The court of appeals therefore distinguished this malpractice case from the cases cited by the Shea Defendants, in which a class member, dissenting from a prior settlement, files a successive action against the same defendants, thereby raising the issues previously decided. Pet. at 39a.

Nearly all of the Shea Defendants' purportedly conflicting cases involve situations other than malpractice. Typically, they hold that a prior class or derivative settlement bars the same plaintiff or a disgruntled fellow shareholder from reasserting the previously settled class or derivative claims against the same defendants in a subsequent class or derivative action. In *Stella v. Kaiser*, 218 F.2d 64 (2d Cir. 1954), for example, a plaintiff that had actively litigated in a settled derivative suit was held to be barred from pursuing a later derivative suit against same defendants. Similarly, in *Ticor Title Ins. Co. v. Brown*, 511 U.S. 117 (1994), this Court held that a mandatory class certification in the prior action barred a dissenting class member from bringing a second class action asserting the same claims on the basis that the prior certification was purportedly improper. In two other cases, this Court and the Third Circuit held that a state-court class settlement barred a subsequent shareholder suit alleging parallel federal claims subject to exclusive federal jurisdiction. *Matsushita Elec. Indus. Co. v. Epstein*, 116 S. Ct. 873 (1996); *Grimes v. Vitalink Communications Corp.*, 17 F.3d 1553 (3d Cir. 1994). The same circumstance of successive class or derivative suits against the original defendants is involved in the district court[8] and prior Ninth Circuit[9] cases cited by the Shea Defendants.

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[8] *See Maldonado v. Flynn*, 573 F. Supp. 684, 686 (S.D.N.Y. 1983) (settlement barred later suit by dissident shareholder to vacate settlement and reassert settled claims); *Bernstein v. Mediobanca Banca di Credito Finanziario*, 78 F.R.D. 1 (S.D.N.Y. 1978) (state court settlement barred later federal derivative suit by different shareholder making same allegations); *Berman v. Thomson*, 403 F. Supp. 695 (N.D. Ill. 1975) (settlement barred later derivative suit filed against same defendants based on same operative facts).

[9] As the court below pointed out, Pet. at 39a, the precluded claims in *Valerio v. Boise Cascade Corp.*, 80 F.R.D. 626 (N.D. Cal. 1978), *aff'd*, 645 F.2d 699 (9th Cir. 1981), were those in which the

(continued ...)

The court of appeals below considered each of these cases and distinguished them. The court noted, "Of course, it is true that courts have precluded subsequent derivative claims by class members collaterally attacking settled derivative actions, . . . but here Durkin is clearly *not* bringing a subsequent derivative action." Pet. at 39a (citation omitted; emphasis in original). As the court concluded, Durkin's malpractice action does not raise "the same issues actually and necessarily decided by Magistrate Judge McCue," but rather "raises two distinct issues that were not decided by Magistrate Judge McCue." Pet. at 35a.

First, the court observed that the issue in a Rule 23.1 settlement hearing is whether "the shareholder plaintiffs adequately represented similarly situated shareholders." Pet. at 35a. But in the malpractice action, the key issue is whether "Shea & Gould adequately represented the interests of a corporation on the eve of its bankruptcy." *Id.* Magistrate McCue made no findings on this point. Moreover, where the corporation is insolvent or nearly insolvent, there is a fiduciary duty to "the entire community of interests in the corporation -- creditors as well as stockholders." *Pepper v. Litton*, 308 U.S. 295, 307 (1939).[10] Thus, there was also an issue as to whether equity holders could represent the

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[9] (... continued)
class members attempted "to reopen a settlement in which they had participated" so as to reassert the original claims. *Goldman v. Northrop Corp.*, 603 F.2d 106, 109 (9th Cir. 1979), similarly held that good-faith derivative settlement barred another shareholder from bringing a second derivative suit alleging related claims that were apparent in the first suit.

[10] *Accord Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991) (directors' fiduciary duties extend to creditors when the corporation is insolvent or operating "in the vicinity of insolvency"); *Geyer v. Ingersoll Publs. Co.*, 621 A.2d 784, 787 (Del. Ch. 1992); *Brown v. Presbyterian Ministers Fund*, 484 F.2d 998, 1005 (3d Cir. 1973).

interests of the corporation as a whole. As the court of appeals found, the prior court did not make findings on that issue: "Magistrate Judge McCue did not decide that the shareholder plaintiffs and their attorneys adequately represented the full corporate interests of ICA." Pet. at 35a.

The Magistrate's finding that the named individual shareholders were "appropriate case fiduciaries" did not deal with the conflict between the equity holders and creditors. CR 463 Ex. B at 3. It appears to have been an attempt to comply with Rule 23.1. By its terms, that rule requires that the plaintiff "fairly and adequately represent the interests of the *shareholders* or members similarly situated in enforcing the right of the corporation or association." Fed. R. Civ. P. 23.1 (emphasis added). This is the only issue with respect to the adequacy of representation that was "necessarily determined" by the prior court. Pet. at 31a, 35a (citing *Montana v. United States*, 440 U.S. 147, 153 (1979)).

Second, the court of appeals recognized that, under state law, the adequacy of the settlement for purposes of approval is not the same issue as that raised in a malpractice action. Pet. at 36a; *see infra* Part II.B. In the Rule 23.1 context, the issue is whether the settlement is "fair and adequate." Pet. at 36a. In the legal malpractice suit, however, the issue is whether, whatever the actual settlement, "'the party would . . . have received a more favorable settlement had the party's incompetent attorney been competent.'" *Id.* (quoting *Ziegelheim v. Apollo*, 607 A.2d 1298, 1305 (N.J. 1992)). In this respect, the court of appeals adhered to the general rule of courts across the country that have considered this issue. In the context of malpractice litigation, these courts have held that a finding of adequacy of a settlement does not bar a claim that more vigorous representation (and a more complete record) would have resulted in the

court's approval of a more substantial settlement. *See infra* p. 24 and note 17 (collecting cases).

That a malpractice action raises different issues than a Rule 23.1 settlement derives from the distinctive nature of malpractice claims. A malpractice claimant does not attack the prior judgment or seek to reassert the settled claims against the original defendants. To the contrary, the malpractice claim assumes the prior judgment, and seeks to hold the lawyer responsible for its entry. Information regarding the prior claims may be submitted to show their merit and value, but those claims are not technically reopened. *See, e.g., Smith v. Lewis*, 530 P.2d 589, 597, 118 Cal. Rptr. 621, 629 (Cal. 1975). "[W]here the client contends that the lawyer's negligence prevented a proper adjudication . . . [c]onsideration by the court of the omitted evidence in the second suit is not a collateral attack on the judgment of the other court in the first suit." 2 Ronald Mallen & Jeffrey Smith, *Legal Malpractice* § 20.13, at 716 (4th ed. 1996) (collecting cases).[11]

Durkin is not arguing that the settlement should be reopened so that a malpractice claim could be pursued against the Shea Defendants.[12] On the contrary, he is

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[11] *See, e.g., Kamilewicz v. Bank of Boston Corp.*, 100 F.3d 1348, 1351 (7th Cir. 1996) (Easterbrook, J., dissenting from denial of en banc review) (a malpractice claim "is not a collateral attack on the judgment. It takes the judgment as a given--indeed, it is only so long as the judgment stands that the litigant has a compensable loss."); *Edmondson v. Dressman*, 469 So. 2d 571, 574 (Ala. 1985) (similar); *Virsen v. Rosso, Beutel, Johnson, Rosso & Ebersold*, 356 N.W.2d 333, 335 (Minn. Ct. App. 1984) (similar); *Rodriguez v. Horton*, 622 P.2d 261, 265 (N.M. Ct. App. 1980) (similar); *Beckwith v. Llewellyn*, 391 S.E.2d 189, 192 (N.C. 1990) (similar).

[12] By contrast, Durkin seeks to rescind transfers made as part of the settlement through fraudulent transfer and preference claims

(continued ...)

asserting an independent malpractice claim against the Shea Defendants based on their conduct in effecting the settlement. As the language and holding of the court of appeals made clear, this malpractice case is properly distinguished from cases involving attempts to reopen prior settlements and reassert the settled claims.

B. The Decision Below Does Not Conflict with the Cited Malpractice Cases.

The Shea Defendants cite three malpractice cases from other circuits that they could have cited below but never did, thereby denying the Ninth Circuit any opportunity to consider the purported conflict. Those cases would not have had any effect, as they involve circumstances so completely different that they have no bearing on this case and do not conflict with the decision below.[13]

In *Laskey v. International Union*, 638 F.2d 954 (6th Cir. 1981), the Sixth Circuit addressed only a single, oblique paragraph to the malpractice claim against the union that had represented the union-member class in the prior action. The court found identity of issues because the plaintiff had been a member of the class being represented by the allegedly negligent counsel. The facts of the counsel's alleged conflicts of interest and errors were known to the prior court and the objectors at the settlement hearing, and the prior court expressly passed on the counsel's representation of the plaintiff. *Id.* at 957. Here, by contrast, the various

[12] (... continued)
against other defendants under the Bankruptcy Code and state law. *See, e.g.*, 11 U.S.C. §§ 547-548. As the court of appeals acknowledged, those avoidance claims "are the subject of district court orders that are not before us." Pet. at 29a & n.9, 30a.

[13] The Shea Defendants also cite a Ninth Circuit case, *Valerio v. Boise Cascade Corp.*, but the court of appeals distinguished it below on the ground that the malpractice claims were dismissed under the statute of limitations, not under a preclusion doctrine. Pet. at 39a.

conflicts of interest were not made known to the court, Magistrate McCue considered only whether the shareholder plaintiffs adequately represented other shareholders, and he made no findings about the Shea Defendants' representation of ICA. Pet. at 35a-36a.

The other malpractice cases cited by the Shea Defendants are inapposite because they did not even involve preclusion defenses. In *Zimmer Paper Prods., Inc. v. Berger & Montague, P.C.*, 758 F.2d 86 (3d Cir. 1985), the court merely determined that, in light of all the evidence, there was no basis for finding that the class counsel had acted negligently. Thus, the Third Circuit considered the malpractice claim on the merits and did not invoke issue preclusion at all.

Finally, the Seventh Circuit's decision in *Kamilewicz v. Bank of Boston Corp.* is so obviously inapposite that the Shea Defendants did not even cite, much less describe, the panel opinion in that case. 92 F.3d 506 (7th Cir. 1996). The Shea Defendants cite only Judge Easterbrook's dissent from denial of en banc review, which *approved* of the court of appeals' opinion below. 100 F.3d 1348 (7th Cir. 1996).[14] The Seventh Circuit panel held that, under the *Rooker-Feldman* doctrine, a federal court could not hear a malpractice action that arose out of entry of a state-court judgment. That doctrine does not apply to Durkin's malpractice claims, which are concerned with conduct leading to a *federal-court* judgment. Indeed, the Seventh Circuit panel acknowledged that its decision would not apply to cases arising out

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[14] The Shea Defendants also note that the decision below is consistent with *Diaz v. Sheppard*, 85 F.3d 1502 (11th Cir. 1996), but mischaracterize that case as involving a "collateral attack" on a class action settlement. Pet. at 17-18. The court merely held that a state-law malpractice action against class counsel arising out of a federal court consent decree did not raise a federal question that allowed removal of the malpractice action from state court.

of a prior federal judgment.[15] Thus, the Shea Defendants have not cited any decisions that conflict with the court of appeals' decision below.

C. This Case Presents Unique Factual Circumstances.

The decision below differs from the cases cited in the Petition for another reason. Alone among the reported cases, Durkin's malpractice action arises from a settlement of derivative claims in the special circumstances of the corporation's insolvency. Although the court of appeals recognized "important public interests" in the finality of derivative settlements, it also noted this Court's admonition that "special circumstances 'may warrant an exception to the normal rules of preclusion.'" Pet. at 40a (quoting *Montana v. United States*, 440 U.S. at 155). As the court of appeals pointed out, this case's "special circumstances" make it different from the typical Rule 23.1 litigation.

Those circumstances take on significance in light of the rule that a judgment can have preclusive effect only where there has been a full and fair opportunity to litigate. *Kremer v. Chemical Constr. Corp.*, 456 U.S. 461, 480-81 & n.22 (1982); *Allen v. McCurry*, 449 U.S. 90, 95 (1980); *Montana*, 440 U.S. at 163-64 & n.11. One element of a full and fair opportunity is that the party to be estopped must have had an adequate incentive to litigate the issue in the prior action. *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 330 (1979).

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[15] The panel distinguished prior circuit precedent holding that a federal court's approval of a settlement as "fair, adequate, and reasonable" did not bar a later state action for misconduct in negotiating and executing the settlement. 92 F.3d at 511 (distinguishing *Derrickson v. City of Danville*, 845 F.2d 715, 723 (7th Cir. 1988) and *In re VMS Secs. Litig.*, 156 F.R.D. 635, 639 (N.D. Ill. 1994)).

Both the district court and the court of appeals held that ICA did not have the requisite full and fair opportunity to litigate the issues pertinent to Durkin's claims. Pet. at 6a, 37a. The court of appeals observed, "Durkin alleges a number of nondisclosures and conflicts of interest, including the retention of Shea & Gould by ICA Board Chairman and *Shields* defendant Allan R. Tessler, who was also 'of counsel' to Shea & Gould at the time of the *Shields* litigation." Pet. at 37a. The court concluded that these conflicts of interest on the part of the plaintiffs, insurers, directors, and the Shea Defendants "necessarily" preclude any finding that ICA had a "'full and fair opportunity' to litigate the adequacy of the settlement for the purposes of a subsequent malpractice action." Pet. at 37a.

This holding stems from the alignment of interests in the prior litigation. ICA was represented by a law firm--Shea & Gould--that had an obvious conflict in representing ICA as plaintiff in the derivative case, since one of the members of the firm, who was also a firm client, was a defendant in the derivative lawsuit. The ICA directors had an interest in obtaining a release of their personal liability before a regulatory takeover or a bankruptcy subjected their arrangement to scrutiny by federal regulators, a bankruptcy trustee, or other representatives of creditors. The shareholders who filed the derivative suit and shareholder class action had an interest in receiving cash immediately. Their equity interests would be subordinated to the interests of creditors in bankruptcy. 11 U.S.C. § 726(a)(6). Thus, any corporate recovery on the derivative claims would go to ICA's creditors, rather than equity. In fact, the shareholders' claims for securities fraud would be subordinated to the claims of all other creditors in bankruptcy and would be practically worthless. 11 U.S.C. § 510(b). Thus, the parties present in court all had an interest in a quick deal that paid cash to

shareholders in exchange for a complete release of the directors.

The court of appeals relied on these circumstances in finding that there was no full and fair opportunity to litigate the pertinent issues in the prior hearing. The court of appeals pointed out that "that the imminent seizure of ISA and bankruptcy of ICA gave all of the parties to the *Shields* settlement 'powerful reasons--not disclosed to the Magistrate--to push a quick settlement through the court *before* the seizure and bankruptcy placed the corporation and its assets under the protection of the bankruptcy court, the RTC, and ICA's trustee.'" Pet. at 37a. The court of appeals' appreciation of the effect of insolvency on the opportunity to litigate fully accords with decisions from outside the circuit. *See, e.g., Remington Rand Corp. v. Amsterdam-Rotterdam Bank*, 68 F.3d 1478, 1486-87 (2d Cir. 1995) (rejecting issue preclusion because corporation's "insolvent condition . . . in the first action" left it with "very little incentive in the [prior] trial to litigate").

The Shea Defendants can point to *no* precedent for the proposition that adherence to Rule 23 or Rule 23.1 procedures is conclusive as to the fullness and fairness of the opportunity to litigate, without regard to the evidence of misconduct or disincentives to litigate that undermined the effectiveness of those procedures in the particular case. Moreover, the Shea Defendants are hard pressed to identify any other case like this one, with facts demonstrating the lack of a full and fair opportunity to litigate in the first instance. Delving further into the unusual and complex facts of this case would not shed any light on the run-of-the-mill Rule 23 or Rule 23.1 cases to which the Petition refers.

II. THE DECISION BELOW RESTS ON INDEPENDENT GROUNDS OF STATE LAW.

Even if the questions presented by the Petition had some merit, this case would not be a suitable vehicle for resolving them. The malpractice claims in this litigation were brought under California law, and the decisions of the district court and court of appeals below relied on independent grounds rooted in California law. The Shea Defendants do not argue that the courts misconstrued California law. In fact, they do not address California law at all. Thus, whatever the Court's decision on issues of federal law, that decision will not affect the result below. As a consequence, the Court should exercise its discretion to decline to review this case.[16]

A. The Court of Appeals' Decision Rests on California Law as to Equitable Estoppel of Malpractice Defendants.

Both courts below recognized that, as a matter of California law, the Shea Defendants may not seek immunity from liability for malpractice by claiming the benefit of a judgment that they negligently helped procure. As the court of appeals noted, a separate ground of the district court's order was that "'the prior adjudication of the adequacy of a settlement does not collaterally estop a legal malpractice claim challenging the conduct of a party's lawyer during the prior action because the essence of such a claim is that the Court's decision approving the settlement would have been different absent the negligence of the party's attorney.'" Pet. at 33a (quoting district court, Pet. at 6a); *see* Pet. at 8.

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[16] *See, e.g., Huddleston v. Dwyer*, 322 U.S. 232, 237 (1944) ("ordinarily we accept and therefore do not review, save in exceptional cases, the considered determination of questions of state law by the intermediate federal appellate courts"); *Butner v. United States*, 440 U.S. 48, 57-58 (1979) (similar); *see also Salve Regina College v. Russell*, 499 U.S. 225, 235 n.3 (1991).

That ruling was rooted in California malpractice law: the district court relied on *Ruffalo v. Patterson*, 285 Cal. Rptr. 647, 648 (Ct. App. 1991). *Id.*

The court of appeals affirmed that state-law ground. The court noted that "the California courts . . . have consistently held that a court-approved settlement or judgment does not immunize an attorney from a subsequent malpractice action." Pet. at 38a-39a. The court relied principally upon a trio of California malpractice cases: *Ruffalo*, 285 Cal. Rptr. at 648; *Garcia v. Borelli*, 180 Cal. Rptr. 768, 772 (Ct. App. 1982); and *Pete v. Henderson*, 269 P.2d 78, 79-80 (Cal. Ct. App. 1954)). These cases recognize that, whatever the ordinary preclusive effect of a court judgment, a malpractice defendant simply is ineligible to claim its protection as a matter of California malpractice law.

The underlying principle is that the attorney is equitably estopped from asserting a preclusion defense. The court of appeals cited as in accord *In re Danelson*, 142 B.R. 932, 939 (Bankr. D. Mont. 1992), in which the court held that an attorney charged with malpractice leading to a court-approved settlement "is equitably estopped from claiming collateral estoppel by [his] professionally negligent misrepresentation." *Id.* at 939, *cited in* Pet. at 39a. California law codifies this principle: "No one can take advantage of his own wrong." Cal. Civ. Code § 3517.

The federal law of issue preclusion leaves ample room for recognition of that substantive doctrine of state law, and there is no conflict between them. California malpractice law does not deny the preclusiveness of the negligently-induced judgment; it merely provides an equitable limitation on who may invoke it. This Court has similarly recognized that "the maxim that no man may take advantage of his own wrong" may equitably bar a defendant from asserting an otherwise valid defense that was made possible by the

defendant's own misconduct. *Glus v. Brooklyn E. Dist. Terminal*, 359 U.S. 231, 232-33 (1959).

In addition, as discussed above, "special circumstances . . . may 'warrant an exception to the normal rules of preclusion.'" Pet. at 32a (quoting *Montana*, 440 U.S. at 155, 164 n.11). In this case, the availability of the defense of collateral estoppel has been circumscribed by well-established equitable doctrines recognized under state law. There is no reason for this Court to review the court of appeals' reasoned application of state law.

B. The Court of Appeals' Application of Issue Preclusion Relies on State-Law Issue Characterization.

The court of appeals also provided an additional, independent ground that depends on an application of state malpractice law. The court held that "the issue of whether a settlement was 'fair and adequate' for the purposes of Rule 23.1 is not the same issue as whether the settlement was reasonable in light of alleged malpractice by the participating attorneys." Pet. at 36a. Application of the requirement of identity of the issues requires proper characterization of the issues in their respective contexts. Citing state-law malpractice cases from California and other jurisdictions, the court of appeals reasoned that the issue in the malpractice action, as defined by state law, is simply not the same as that under Rule 23.1. *Id.* at 1516 (citing *Ruffalo*, 285 Cal. Rptr. at 648; *Garcia*, 180 Cal. Rptr. at 772; *Danelson*, 142 B.R. at 932; *Ziegelheim v. Apollo*, 607 A.2d 1298, 1304-05 (N.J. 1992) (collecting cases from several states)).[17] It could not be otherwise: as one court noted, "counsel . . .

[17] *Accord Keramati v. Schackow*, 553 So. 2d 741, 744-45 (Fla. Dist. Ct. App. 1989); *Prande v. Bell*, 660 A.2d 1055, 1063-64 (Md. Ct. Spec. App. 1995); *Baldridge v. Lacks*, 883 S.W.2d 947, 951 (Mo.

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are interested in obtaining approval, not disapproval, of the proposed settlement, and the . . . attorney, surely, is unlikely to use the occasion [of the settlement hearing] to confess any professional inadequacy." *Cook v. Connolly*, 366 N.W.2d 287, 290-91 (Minn. 1985).

The court of appeals recognized the national consensus of state malpractice law on this issue. The Shea Defendants do not acknowledge it other than by dismissing the significance of state supreme courts. *See* Pet. at 19 n.22. Given the reliance of the courts below on what is uncontrovertedly the law of California, further analysis by this Court of any federal issues would not affect the result.

III. THE PETITION DOES NOT PRESENT AN APPROPRIATE VEHICLE FOR DECIDING THE QUESTIONS PRESENTED.

The Petition does not present an appropriate vehicle for deciding the highly fact-bound issues that it raises. The court of appeals affirmed the denial of summary judgment in part because there were genuine issues of material fact that could "'only be properly resolved once the relevant discovery, which has barely begun, can be reviewed.'" Pet. at 38a (quoting district court). The Shea Defendants have pursued an interlocutory appeal based on an incipient factual record. Because of a stay pending appeal, that record is still not complete. This case thus fully warrants application of the Court's long-standing general rule against granting of certiorari where there is no final judgment below. *See American Constr. Co. v. Jacksonville, T. & K. Ry.*, 148 U.S. 372, 384 (1893); *Hamilton-Brown Shoe Co. v. Wolf Bros. & Co.*,

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[17] (... continued)
Ct. App. 1994); *Weiss v. Manfredi*, 639 N.E.2d 1122, 1123-24, 616 N.Y.S.2d 325, 326-27 (1994); *Beckwith v. Llewellyn*, 391 S.E.2d 189, 191 (N.C. 1990); *Barr v. Day*, 879 P.2d 912, 915-16 (Wash. 1994).

240 U.S. 251, 258 (1916); *Brotherhood of Locomotive Firemen v. Bangor & A. R.R.*, 389 U.S. 327, 328 (1967).

The motion for summary judgment leading to the decisions below was briefed and heard by the district court before Durkin had received the voluminous documents produced by the parties or was allowed to take any depositions. More than 60 depositions have been taken since that time. Discovery was stayed pending the Ninth Circuit appeals but has now resumed.

In this interlocutory context, in addition to the legal flaws in the Shea Defendants' contentions, there were factual disputes that precluded summary judgment. As the court of appeals concluded, there are "questions of fact" as to "the existence and nature of any duties owed by Shea & Gould to ICA," and well as issues as to "'whether the Shea defendants breached any duty to ICA in connection with the *Shields* litigation.'" Pet. at 38a (quoting district court). The parties apparently contest what the Shea Defendants were hired to do, what they in fact did, and what effect it had on the settlement. "'California law has evolved the proposition that the issue of attorney malpractice is in essence a question of fact,'" and "proof relative to these issues generally requires the testimony of experts as to the standards of care and consequences of breach." *Lipscomb v. Krause*, 151 Cal. Rptr. 465, 468 (Ct. App. 1978) (citation omitted); *see Kirsch v. Duryea*, 578 P.2d 935, 940, 146 Cal. Rptr. 218, 223 (1978). The scope of the Shea Defendants' duty and whether the duty was breached involve complex factual predicates that have yet to be fully explored in discovery.

The Shea Defendants go so far as to argue, in essence, that *none* of the counsel had responsibility for the approval of the settlement, and that it was the court itself that allowed ICA's claims to be released. Pet. at 24-25. The record here contradicts that assertion. In presenting the

settlement, the parties told Magistrate McCue that he should not seek to substitute his own business judgment for that of the parties.[18] Moreover, not a single case suggests that the judge's role somehow exonerates the representative parties or counsel of their duties to the represented corporation. It is difficult to see how that could be the case. The judge can act only on the basis of the record made by the parties. *See, e.g., Cook v. Connolly*, 366 N.W.2d at 290-91. In the prior litigation, the record before Magistrate McCue was patently inadequate because of, among other things, the Shea Defendants' malpractice.

Many of the Shea Defendants' arguments rest on factual assumptions about the limited scope of their duties, or the role of the shareholder plaintiffs. But the record on those issues is not fully developed at this time. The district court lifted the stay on discovery effective March 13, 1997, and depositions will begin again in mid-April. New facts may be expected daily. It would be pointless to have an argument before the Supreme Court based on either a stale record or a new record in a state of flux.

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[18] CR 490 Ex. V at 17-18. As Wright and Miller describe the federal Rule 23.1 standard, "the court should not substitute its judgment of what is in the best interests of the parties." 7C Charles A. Wright, Arthur R. Miller & Mary K. Kane, *Federal Practice and Procedure* § 1839, at 182-87 (1986). There is no evidence that Magistrate McCue conducted a Delaware Chancery Court fairness hearing, which would have mandated an extensive evidentiary inquiry. *See, e.g., Neponsit Inv. Co. v. Abramson*, 405 A.2d 97, 100 (Del. 1979); *Polk v. Good*, 507 A.2d 531, 536 (Del. 1986); *Perrine v. Pennroad Corp.*, 47 A.2d 479, 484-85 (Del. 1946). As a result, the Delaware state court authority cited in the Petition does not apply. *See* Pet. at 16 n.18.

CONCLUSION

The Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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